

APPENDIX

Notes for FOMC Meeting
November 13, 1990
Sam Y. Cross

Since your last meeting the dollar has declined by 4 to 6 percent against most currencies as the negative sentiment we have seen for some time deepened. The dollar set all-time lows against the German mark, the Swiss franc, and the Board's trade-weighted index.

A variety of factors contributed to this negative sentiment. First was the overall weakness in the U.S. economy in general and concerns about the banking sector in particular. Second, was the presumption that the Federal Reserve would ease, not only immediately after resolution of the budget crisis, but possibly one or more times in the period ahead. Third, was the prolonged budget stalemate, which was taken as evidence of serious disarray in the U.S. government. Fourth was the shift towards expectations of higher interest rates abroad confirmed by the Bundesbank's increase in its Lombard rate and the associated rate hikes in a number of other European countries. And finally, there was a perception that much of the official sector, both in the United States and abroad, was either indifferent to the dollar's decline or actually welcomed it.

Under these circumstances the dollar generally followed a declining trend, although there have been a couple of factors tending to moderate the decline. First, there were interruptions or temporary reversals of the dollar's fall from time to time when fears of immediate war in the Middle East sharpened. Second, as the dollar reached lower and lower levels there was increasing apprehension that monetary authorities here and abroad might act to stem the dollar's decline. With the dollar having moved down as much as it has in

recent months, and with many market observers having concluded that the dollar has reach quite competitive levels and has no intrinsic need to decline further, there is some wariness of the possibility of central bank intervention and a sharp upward move in the dollar.

Even so, the prevailing market view is that the dollar will continue on the generally downward trend that has persisted since the spring, and in that environment there is considerable market gloom over the prospects for U.S. macroeconomic and financial performance. There are concerns about our ability to attract financing at interest rates consistent with our domestic economic situation, concerns about the domestic inflation implications of the dollar's decline, and concerns about a possible sudden loss of market confidence which could spread to other financial markets and damage the international monetary system.

In recent weeks there have been some expressions of anxiety from foreign officials about the weakening dollar. The French have been the most vocal, including Finance Minister Berezovoy's letter to Secretary Brady last week, expressing worries over the implications of the declining dollar for the stability of the international economy and the cohesiveness of the G-7 coordination process. The Germans, who see the advantages of a strong Deutsche mark for their own needs, have tended to focus on the positive implications of a lower dollar.

In recent weeks the U.S. Treasury has made some effort to dispel the widespread notion that officials there are indifferent to the dollar's decline. There have been public comments by Treasury officials expressing concern over the dollar's decline and in private

discussions there appears to be an increased willingness to consider possible action to halt the decline if it should continue.

One factor that seems to have affected the liquidity of the market during this period deserves mention. With the increased attention on the condition of major U.S. banks, we have heard from market contacts on numerous occasions that several of the larger U.S. banks were encountering some reluctance to deal on the part of counterparties--foreign and even, in some cases, other U.S. institutions. We are told that the affected institutions may be cutting back their own position-taking activity as a defensive measure, because they cannot be assured of the same level of liquidity they previously enjoyed, and scaling back their presence in the foreign exchange market. Some brokers tell us that their turnover declined by as much as 15 percent over the over the past month or so. So far, we have not seen this reported decrease in liquidity translate into a substantial increase in volatility, but that could occur if these conditions continue.

Since the last FOMC meeting, the Desk has not intervened in the foreign exchange market.

On November 1, the ESF repurchased from the Federal Reserve \$2.5 billion of warehoused German marks, reducing the amount of warehoused marks outstanding to \$4.5 billion. The ESF covered \$1 billion of the reversal out of its dollar balances. The remainder was covered by the issue on October 31 of \$1.5 billion in SDR certificates. It was possible to issue more SDR certificates because the dollar value of SDR certificates increased as the exchange rate fell.

Mr. Chairman, I would like to request that the Committee authorize renewal of our swap lines with foreign central banks on the existing terms and conditions. We would like to discuss this matter with the counter party central banks over the coming weeks and report back to the Committee if there are any proposed modifications.

NOTES FOR FOMC
PETER D. STERNLIGHT
NOVEMBER 13, 1990

Domestic Desk operations since the last meeting sought to hold reserve pressures steady through most of the period, but then in the final two weeks, we sought to bring about a slight reduction in those pressures consistent with fed funds varying around 7-3/4 percent compared with 8 percent earlier. The easing move on October 29 followed Congressional action, after months of wrangling, on a budget deficit reduction package. The move was also made in the context of the Committee's evaluation at its last meeting that the economy is quite soft. The background for operations during the period included a continuing flow of information on the economy that suggested little growth, and quite possibly some over-all declines in activity, a continuing concern about political and military developments in the Middle East with implications for oil prices and inflation generally, and growing concerns about fragility in the U.S. financial system.

The borrowing allowance was reduced several times during the period, mainly to keep pace with the usual reduction of seasonal borrowing typical of this time of year. The \$50 million reduction on October 29 reflected both a recognition of lower seasonal borrowing and that day's intended modest reduction in reserve pressures. In all, the reductions totaled \$200 million, bringing the path level down to \$300 million. Actual borrowing levels turned out fairly close to path, as the end-of-period bulges characteristic of the previous intermeeting period did not occur this time. Borrowing averaged \$340 million for the full period.

There did continue to be some greater-than-intended firmness in funds trading on a number of days, however, as banks persisted in

cautious reserve management behavior in order to avoid getting caught short late in the maintenance period and risk being perceived either as having to pay up in the funds market or turn to the discount window. Funds averaged 8.08 percent in each of the first two full maintenance periods and even in the first week of the current period, with the expected rate reduced to 7-3/4 percent, funds averaged only a shade below 8 percent. In the last few days, after some relatively energetic reserve injections to accommodate the cautious reserve management practice of the banks, the rate has been close to the expected 7-3/4 percent level, or a shade below--perhaps because the market expects a further easing. Even when the funds rate deviated from expectations, however, market participants seemed to have no doubts about the System's intentions.

Desk operations were largely on the reserve supplying side, keeping up with currency increases, although slow deposit growth tended to hold down required reserve increases. Reserve needs were augmented late in the period because of a "dewarehousing" of some of the Treasury's store of D-marks. This was helpful in putting off, for a time, a likelihood of running into a shortage of authorized collateral to back currency outstanding. Over the whole period, outright holdings of Treasury issues were increased by about \$4-1/2 billion, the bulk of it through a market purchase of bills on October 31 and the rest through occasional purchases from foreign accounts. This was supplemented on a number of days with rounds of System or customer-related repurchase agreements, while on one occasion a temporary overabundance of reserves was absorbed through some matched sale-purchase transactions in the market.

Debt markets were subjected to increasing quality concerns during the intermeeting period. For Treasury securities, this was a

plus factor which, along with the flow of indications of weakness in the economy, outweighed the continuing inflation concerns stemming from worries about the Middle East and the prospect and actuality of huge supplies of new issues. The net result was a moderate rate decline through the whole maturity spectrum for Treasury issues. At times, however, there were upward pressures on rates, such as when the Congress initially rejected the budget agreement worked out by the Administration and legislative leaders just before the last Committee meeting. Another back-up occurred when the third quarter GNP was reported, with its surprisingly high growth, and intermittently reports or rumor of imminent war in the Middle East sent oil prices up and bond prices down. But the Congress did eventually cobble together a budget pact and the main flow of news on the economy was distinctly on the soft side--to the extent that most market participants and analysts now regard the economy as in at least a mild recession. Views on inflation are mixed, with a few seeing it as "no problem" now while many others regard it as temporarily subdued by recessionary forces. In this setting, there is a widespread market expectation of further accommodative monetary policy moves near-term. A few look for relatively aggressive moves in view of the perceived weakness in the economy and fragility of the financial system, while most seem to anticipate more modest and gradual steps in order to minimize damage to the dollar and later inflation problems. At least with respect to modest policy moves, one hears relatively little now about the risk to the central bank's long-term credibility as an inflation fighter.

Over the period, Treasury coupon yields were down about 30-35 basis points for maturities out to about seven years, while longer yields were off about 25-30 basis points. The Treasury raised about \$19 billion in the coupon market, more than half of it in the record

quarterly financing auctioned last week and settling this Thursday. Given the weak economic climate and investors' quality concerns, those auctions saw good bidding. The longer maturities are reportedly not all distributed, but dealers seem comfortable holding them for now.

Bill rates came down only a modest 10-25 basis points over the period, partly reflecting the extent of their move prior to the last meeting and the fact that the Treasury raised an enormous \$35 billion in this sector, including \$2 billion in the record weekly issues just sold earlier this afternoon. In those auctions, we estimate that the 3- and 6-month issues went at about 7.06 and 7.03 percent compared with 7.18 and 7.21 percent just before the last meeting.

In all, the current quarter is shaping up to be by far a record-breaker for net Treasury borrowing from the public, surpassing the last quarter's record \$64 billion by some \$20 billion or more.

Indicative of quality concerns, spreads on private high-grade short-term instruments over Treasury bills widened a bit, except for very short paper where there had already been some widening around the last quarter end. Moreover, within private instruments quality differentials pressed somewhat wider. To some extent this reflected the prospective application of new SEC rules severely limiting the ability of money funds to hold any but the very highest rated paper--but the cautious inclinations of investors played a part as well.

More dramatic evidence of credit quality worries showed up in longer-term markets. So-called junk bonds have of course been out of favor for months, trading in very thin markets and treated more like equities than bonds. On average, their spreads over Treasuries widened somewhat further. Perhaps more significant what we have seen more of in the recent period is the market's effective downgrading of

medium-grade credits to be regarded as closer to the "junk" category--even when retaining investment grade ratings from the major services. This has been notably the case with selected bank holding company paper. An outstanding example was Citicorp, for whose 10-year notes the quoted market spread over Treasury paper widened by roughly 200 basis points--that is, from around 3 to around 5 percentage points. Even bigger moves occurred in the auction-set rates on certain issues of their preferred stock. It's not that Citicorp is suddenly being equated in investors' minds with, say, Trump's casino hotels, but there is a measurably greater degree of caution toward what have been long regarded as solid investments.

To my mind there is an extra dimension to the caution manifested nowadays, in that the industries whose particular business it is to evaluate credits are themselves coming under closer scrutiny and question--whether it is commercial banks, investment banks, or insurance companies. It makes for a very edgy atmosphere, in which everyone looks over his shoulder with apprehension about how his own operations may be evaluated. Further adding to tensions just now is the approach of year-end, as there will be a particularly close focus on what kinds of investment are shown in year-end statements, and especially for banks what kind of capital ratios are reported. I should note at the same time that there is considerable advance preparation going on for year-end, so the event may prove to be less onerous than the anticipation. There is also an anticipation that the Fed will be prepared to provide liquidity, if needed--but that does not, of course, relieve all the credit quality anxieties; there is still worry about one or another major entity coming up short.

Finally, I should mention another defection from the ranks of primary dealers. Wertheim Schroder decided about two weeks ago to

withdraw as a dealer in view of weak profitability. The firm had been a primary dealer only since 1988. Their losses were mainly in areas other than government securities, but the experience caused them to reassess their activities over a broad range and they decided to concentrate on what had been their more traditional activities. This was the fifth withdrawal from dealerships this year, reducing the number to 40. Actually the profit experience this year for the group as a whole is appreciably better than last year, but the experience is quite mixed with a large minority still in the loss column.

November 13, 1990

Briefing on the Directive
Donald L. Kohn

At the last meeting, Chairman Greenspan asked the staff to consider possible changes to the last sentence of the directive. A staff memorandum on this subject was distributed to the Committee. In considering alternative wording, we worked under the assumptions that current procedures for implementing policy and current understandings with regard to flexibility built into policy implementation would not be changed. We recognize that there are reasons to be dissatisfied with current operating procedures, but we have no suggestions at this time for fundamental change that don't seem to raise more issues than they resolve.

In that context, we confronted a number of problems and constraints in our approach to the last sentence.

First, the current sentence is clearly outmoded and does not describe Committee practice or understanding.

Second, in designing a new sentence, the Committee would not want to lock itself into the narrow funds rate targeting that prevailed in the late 1970s--or give the impression that it was in the process of doing so.

Third, any new sentence should not override the flexibility now built into the directive with regard to intermeeting adjustments to policy. That flexibility derives from the contingency sentence with the "woulds" and "mights", and often encompasses complex understandings among Committee members about the conditions for consultation. In effect, any new sentence would have to convey the impression that events would have to deviate by more than already contemplated in the contingency sentence.

Finally, recent news stories have stated that because of dissatisfaction among some Committee members or their staffs new operating procedures are being considered. As a consequence of this publicity, any change in the directive will be scrutinized more carefully than usual, and will engender expectations that it signifies some change in operating procedures as well.

We did not come up with any alternatives that satisfy all these conditions. Something like alternative 4, which references economic and financial conditions, appears to come closest to current understandings, but its wording does not seem to allow for the usual degree of flexibility in the contingency sentence before triggering consultation.

In these circumstances, unless there is a wording suggestion that better captures the Committee's practices, I would recommend either alternative 1--do nothing--or alternative 5--drop the sentence altogether. Whatever alternative is chosen, the policy record could describe the Committee's rationale and the relationship of the sentence it selected to operating procedures.

Michael J. Prell
November 13, 1990

FOMC BRIEFING -- ECONOMIC OUTLOOK

You may recall that, last month, after I delivered an extraordinarily lucid briefing, Governor Mullins asked a question that went something like this: "Let me get this straight: You're predicting a downturn in the economy, but you don't believe it." I responded that, although it might have sounded like that, what I'd intended to communicate was that we were expecting a downturn but that it really wasn't yet visible in the data. Today, I'd have to say that the signals of a downturn still are limited, but there certainly are some now.

The most compelling signals have come from the labor market. The drop in employment and hours in the mid-October surveys, the jump in claims for unemployment benefits later in the month, and the many announcements of layoffs all point to falling output. With other data also on the weak side, we published this morning an 8/10 of a percent decline in industrial production for October. Moreover, apparently responding in part to the crash in consumer sentiment registered by various surveys, the auto manufacturers have announced cutbacks in car and truck assemblies that will depress industrial output over the remainder of the quarter.

All told, the incoming information has been soft enough to lead us to mark down our forecast of real GNP growth in the current quarter, from a minus 1 percent to a minus 2 percent annual rate--with, of course, a still wide confidence interval. But we also have

carried some of this added weakness into the first half of 1991, and with the subsequent recovery remaining subdued, the unemployment rate reaches 6-3/4 percent--a quarter point more than in our previous forecast.

The somewhat weaker overall trajectory of real GNP reflects, basically, a reassessment of the prospects for expansion of domestic final demand. Admittedly, there is not a great deal of hard information to go on here, and we have been influenced by such things as the anecdotal reports suggesting that consumer and business spending may have dropped off more sharply of late than we had anticipated--or than is yet apparent in the data. Given underlying wealth and cash flow trends, a correspondingly sharp snapback in demand does not seem likely.

Also arguing against such a snapback is the credit situation, which, as Peter has noted, has worsened. Our assessment is that the constriction of credit supplies by banks and other intermediaries and the increases in risk premiums on securities have progressed further at this juncture than we previously had anticipated they would. We also do not believe that we have seen the end of this process: the cost and availability of credit is likely to tighten further in the months ahead, in part because the recession will surface more of the latent financial vulnerabilities. Indeed, we have assumed that things will not improve much before 1992, if then.

Now, the period since the last meeting of the Committee hasn't been entirely devoid of good news. In particular, there have been a few favorable developments on the inflation front. To be sure,

the overall increases in the PPI and CPI have been grotesquely large in the past few months, but there have not been any signs that the underlying trends, after one strips away the energy bulge, have deteriorated further. Meanwhile, consistent with the drop-off in industrial activity, the prices of metals and other non-petroleum commodities have fallen considerably, despite the depreciation of the dollar. And more important, the third-quarter employment cost indexes and the October figures on average hourly earnings suggest that wage trends may be more favorable than was indicated by earlier data. Those figures have led us to slice a little off of our estimate of the underlying trend for compensation. The more optimistic reading on the present degree of cost pressure and the weaker output path combine to produce a noticeably better inflation result by 1992, when, in this projection, the rate of CPI increase moves below 4 percent.

Whether such a combination of somewhat higher unemployment and somewhat lower inflation--relative to our previous forecast--is one with which a majority of the Committee would be comfortable, I don't know. In seeking to provide a reasonable baseline for your discussion, we simply thought it might be useful to produce a projection based on an assumption that the funds rate remained at its current level for a while.

That said, in light of the asymmetry of the Committee's recent directives, it might be appropriate to make the obvious point that, if you were to push the funds rate down appreciably in the coming weeks or months, it would tend to raise output after a short time--and it also would tend to reduce the degree of disinflation, but

with a somewhat longer lag. I hesitate to attempt to quantify those effects, because the baseline projection already contains so much uncertainty; however, it may be useful to remark that our model simulations support the notion that it will take substantial easing actions to materially alter the outlook.

For example, if you accept our judgmental Greenbook path as the starting point for the analysis, the models tell us that, even with an immediate cut in the funds rate to 7 percent, the jobless rate still would reach 6-1/2 percent by next spring. Of course, the subsequent recovery would be stronger, owing in part to the depreciation of the dollar that such an easing would be expected to induce. If the funds rate were held at 7 percent, the unemployment rate would drift back down toward 6 percent by the end of 1992; however, the cost of this approach would be that prices would rise 4-1/2 percent, instead of 4 percent, in 1992 and would show only a slight tendency to decelerate further.

Of course, one could devise a variety of alternative simulations, including strategies of easing more aggressively now and then tightening later to head off greater inflationary pressures. However, it seems to me that such exercises would have an especially ethereal quality in the present context. As we have stressed before, the range of possible outcomes for oil prices is enormous, and we have adopted a rather benign assumption--notably, one that does not encompass the kind of supply disruption that might occur if there were to be a war in the Gulf. And, of course, the economic implications of the financial stress we are observing are impossible to gauge with any

precision. The gross uncertainties associated with the oil and credit phenomena alone argue against putting much weight on precisely calibrated alternative projections. Rather, I would encourage you to focus on a few key questions about our baseline forecast: namely, whether the contractionary forces currently are as moderate, and as much related to the oil price rise, as we have indicated; whether those contractionary forces are likely to intensify or ease in the coming months at current money market interest rates; and whether the core rate of inflation can be reduced significantly without an appreciable slackening in resource utilization.

Ted will now offer some comments on the outlook for the external sector.

E. M. Truman
November 13, 1990

FOMC Presentation -- International Developments

As with the overall staff forecast that Mike has just described, the basic trends in the international outlook are essentially the same as those we have presented at the previous two meetings. As Mike noted, we have not changed our assumption about oil prices, though in the past few days oil has been trading at prices somewhat below those implicit in that assumption.

We have made some changes in our forecast. With the decline in the dollar over the intermeeting period, we lowered the level of the dollar in this forecast around 5 percent, but we have held it unchanged at that lower level. We are also projecting somewhat slower growth on average in the foreign industrial countries -- a touch less than 3 percent at an annual rate in 1991 and 1992 compared with slightly more than 3 percent in the previous forecast. This change is primarily the result of changes in our outlook for Canada and the United Kingdom, which appear to have moved into deeper recession than we earlier projected. Mike has just described the downward revision in U.S. economic activity which is a bit larger than the similar adjustment in foreign growth. The net result of these changes is a somewhat larger contribution by the external sector to the projected recovery of the U.S. economy. I will return in a few moments to the issue of longer-term changes in our outlook for

the external sector over the past several forecasts and the influence of the lower dollar.

With respect to near-term developments, the August data on merchandise trade were about in line with our expectations. For July and August combined, exports were about flat largely as a result of a fall-off in aircraft shipments that offset increases in other categories. Non-oil imports recorded considerable increases, especially in the automobile, consumer goods and capital goods categories. These increases were loosely consistent with the rise in domestic demand in the third quarter. However, we anticipate that non-oil imports dropped off in September to a level substantially below that implicit in the advance GNP release.

One noticeable feature of the data so far available for the third quarter was the substantial rise in non-oil import prices; on a fixed-weight basis, these prices rose at an annual rate of 3.6 percent. The sharp increase recorded in September, along with the further decline of the dollar, leads us to expect an even larger rise in the prices of non-oil imports in the fourth quarter. Of course, sharp rises in prices of oil imports also continued into the fourth quarter, and they will boost the nominal trade deficit.

On the real side in the fourth quarter, we are projecting a pickup in agricultural export shipments from the depressed rate in the third quarter, a moderate expansion in non-agricultural exports, and an increase in military sales to Saudi Arabia. At the same time, the quantities of our non-oil imports

should drop off with the decline in the domestic economy, and oil imports are expected to be little changed from their rate in the third quarter. All this suggests a boost in real net exports of goods and services in the fourth quarter, but most of it comes on the import side.

As I already have noted, real net exports are projected to provide an important underpinning to the economy over the forecast period. Our projections of net exports of goods and services have been revised upward substantially over the past several forecast rounds. While special factors have played a role in our revisions, a large proportion of the net change can be attributed to the influence of fundamental factors: The weighted-average, foreign exchange value of the dollar is now 11-1/2 percent lower. The level of U.S. real GNP in the fourth quarter of 1991 is now projected to be about 1-3/4 percent less than in the forecast prepared for the July FOMC meeting. The projected level of real GNP in the foreign industrial countries is a bit less than 1 percent lower at the end of 1991.

On balance, real net exports of goods and services are now projected to increase about \$50 billion between the second quarter of 1990 and the fourth quarter of 1991, compared with our forecast in July that the increase would amount to only about \$20 billion. The \$30 billion difference amounts to almost 3/4 of a percent of real GNP. While it is not easy to determine what is endogenous and what is exogenous in our forecasts, a substantial part, about \$25 billion, of the revision in net exports since July can be directly attributed to the lower dollar. At the same

time, the lower level of U.S. economic activity contributes about \$10 billion to real net exports through reduced imports, but lower activity abroad subtracts about \$5 billion from exports. In other words, while a considerable proportion of the upward revision in our forecasts for real net exports over the past several months has been via the exchange rate channel, an important component reflects differences in growth rates; on the domestic side, imports are one of the automatic stabilizers in the economy.

Mr. Chairman, that concludes our presentation.

November 13, 1990

FOMC Briefing
Donald L. Kohn

The issue confronting the Committee at this meeting would seem to be one-sided--that is, whether to ease and if so by how much. An easing at this time is unlikely to affect the trajectory for the economy over the next quarter or so, but will have its major impact on the likelihood and strength of any rebound next year. As Mike and Ted noted, in the staff forecast that rebound is built on the effects of strength in net exports and an assumed decline of oil prices. The possibility that the recovery would be damped because oil prices might remain high is not itself a reason to ease policy. Higher oil prices also would add to price pressures, and leaning against the additional softening in the economy could have further adverse implications for inflation.

But an easing to stimulate the economy next year would be justified if it were felt that, apart from the possible effects of added oil price pressures, the economy will be substantially weaker in some underlying sense than in the staff forecast. Alternatively, it might be felt that the assessment of the economy in the staff forecast was about right, but that the outcome implied a lower track for economic activity in 1991 and 1992 than the Committee would find desirable or necessary to achieve its inflation objectives.

Certainly the money supply numbers seem to be flashing a cautionary signal with regard to the trajectory for the economy. The growth of all the Ms has been substantially weaker than was anticipated

at the time of the last meeting. We are now projecting M2 growth of only 1-1/2 percent from September to December, down from 4 percent at the last meeting. The projection has been revised down despite the decline in short-term rates, and includes a substantial pickup of growth projected for December.

The slow growth of money in the face of declining interest rates and opportunity costs may signal greater weakness in contemporaneous or recent income than now evident in the data. Looking forward, weak money growth in the past has often preceded weak income growth as money responded to a tightening of money market conditions and interest rates as the Federal Reserve fought inflationary tendencies. The rise in interest rates affected the public's asset portfolio before it affected its spending. In the current situation, interest rates have been falling, not rising, at least in the short- and intermediate-term maturities.

The weakness in money may, however, be telling us something about future income growth via a different channel; that is, it may be indicative of a disruption to the credit and intermediation process. If banks, not wishing to make loans, are less aggressive in going after deposits, and depositors are a bit wary of banks given recent publicity, shortfalls in money growth may still be a leading indicator of tightening credit markets and weak income growth. However, any such implications must be drawn with great care. For some time, M2 has been growing slower than past relationships with income and opportunity costs would have suggested--that is, a considerable portion of the slowdown in money

is showing up as an unexpected rise in velocity, rather than a damping of income growth, and this tendency is expected to persist.

Our survey results leave little doubt that banks have continued to raise standards for approving new loans and to tighten terms on loans they do make. Considerably greater caution at banks is in evidence across a wide spectrum of business lending, and shows some signs of extending to lending to the household sector. Attempts to rebuild bank profit margins can also be seen in the stickiness of the prime rate relative to market rates. In addition, other intermediaries have begun to meet resistance to the acceptance of their liabilities in credit markets and can be expected to begin to cut back on credit commitments and to tighten terms, leaving rejected bank loan applicants with fewer alternatives. Institutional investors have become more selective, with the results showing up not only in rising spreads on bank debt, but in widespread increases in risk premia on borrowers below the very top grade.

While there can be little doubt that credit restrictions have deepened and become more widespread, the extent to which this will continue and impinge upon the expected recovery next year is difficult to judge. Some of the pressures now evident in markets may be accentuated by balance sheet restructurings in advance of year-end. That is, some of the extreme weakness in money and severe tightening of credit terms and availability may be part of a portfolio adjustment process that has been telescoped into a few months by the urgency of approaching statement publication dates. And, markets may already have discounted the

worst about impending losses, building them into risk premiums and restrictions on credit lines. Constraints on credit supplies are unlikely to be reversed in the new year, but once portfolios are readjusted and margins re-established, credit may not be tightening as rapidly as it seems to have been recently. Still, even on this less pessimistic interpretation of current developments in credit markets, there is some danger of an interactive process involving credit cutbacks and asset prices that could feed on itself and deepen the economic slump.

The movements, levels, and structure of interest rates do not seem to suggest expectations of, or conditions leading to, a deep recession with little rebound. As I already noted, market interest rates have been falling, not rising as they usually do prior to a recession. Of course rates and other lending terms are tightening for a large number of borrowers, and credit is simply not available to its previous extent. Even so, the decline in market interest rates to date may help to cushion these effects.

It seems likely that real rates have fallen along with most market rates. Our standard calculations using recent past inflation or results of surveys to derive measures of expected inflation and real interest rates probably exaggerate the extent to which real rates have declined--especially for purchases other than those related to energy. Even so, the decline in the dollar, while probably reflecting monetary restraint abroad, also seems to suggest monetary ease in the United

States, and as Ted noted, provides considerable impetus for a stronger economy next year.

Bond markets have rallied substantially in recent days, perhaps on hopes of some moderation in price pressures, the beginnings of which may have been seen in recent price and cost measures. To be sure, long-term rates retain some uncertainty premium associated with the Middle East. Still, the term structure of interest rates, which retains an upward slope, and the level of long-term rates both suggest that markets still do not appear to expect a deep recession, appreciable progress in reducing inflation, or a prolonged period of Federal Reserve ease beyond the modest near-term easing now widely anticipated. On the other hand, the decline in the stock market since this summer, and, in recent weeks, the broad drop in commodity prices are consistent with a significant degree of restraint on economic activity, arising perhaps from the credit markets.

A view that the credit tightening, and associated monetary shortfall, was not likely to be severe enough to greatly deepen the recession or impede the recovery would weigh in favor of a very cautious approach to easing policy at this time. This might argue for unchanged reserve conditions, as under alternative B, but retaining the asymmetry toward ease for intermeeting adjustments. As Mike noted, the staff forecast does not assume any further policy ease for some time, and this choice would be consistent with the notion that the staff outlook is acceptable, and that the risks around that outlook for the depth of the recession and the vigor of the rebound are reasonably balanced.

Maintaining reserve conditions unchanged would also be consistent with concerns that further ease risked a sizable decline in the dollar, which would intensify price pressures. The drop in the dollar is likely to be greater if the ease were seen as suggesting a reduced commitment to containing inflation. If that view were to prevail in markets, long-term rates could even rise if policy were to ease.

An easing of policy, as under alternative A or some lesser easing move, would imply that the Committee saw the kind of outcome contained in the staff forecast as not satisfactory, or saw the risks as weighted to the side of a greater shortfall in output or weaker recovery, perhaps because of the problems in the financial system. Depending on the degree of ease, the decline in the dollar might be relatively contained, since markets already have some further easing built in. In any case, if the risks are seen on the side of a weaker economy, some decline in the dollar may be essential to an effective monetary policy. Reducing short-term rates will help stimulate domestic credit, and not only for those borrowers currently with access to credit markets. Even recalcitrant lenders would find incentives to extend credit at the higher margins that would prevail initially, and ultimately some of those lower costs are likely to be passed along to many of their borrowers. Still, some of the decline in rates might be absorbed into lender margins and intermediated credit might not respond in the current circumstances as much as previously. This raises the possibility that a some-

what larger easing of policy might be needed to provide the same stimulus, with, as a consequence, greater reliance on the exchange rate channel for policy effects.